

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Knight Analyst: Gloria McConnell Bill Number: SB 704
Related Bills: See Legislative History Telephone: 845-4336 Amended Date: 05/14/01
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Tax Refund Fairness Act of 2001/Simple Interest Shall be Paid on Overpayments of Tax

SUMMARY

This bill would require the Franchise Tax Board (FTB) to pay simple interest on refunds from the date of the tax overpayment to the date the amount is paid to the taxpayer.

SUMMARY OF AMENDMENTS

The May 14, 2001, amendments deleted the provisions of the bill as introduced and added the provisions discussed in this analysis.

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

The stated legislative purpose of the bill is to restore to taxpayers the full and fair value of their income tax dollars that are overpaid to the state.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative on January 1, 2002.

POSITION

Pending.

Summary of Suggested Amendments

Potential amendments are discussed under "Implementation Considerations."

ANALYSIS

FEDERAL/STATE LAW

Personal Income Tax Administration

FTB administers the Personal and Bank and Corporation Tax Laws. Employment Development Department (EDD) administers the laws relating to the withholding of personal income tax (PIT) by an employer from the taxpayer's wages.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Alan Hunter for GHG

06/20/01

The amount of PIT paid through employer withholding is allowed as a credit against the taxpayer's PIT liability for the year that the amount was withheld.

Overpayment of Tax

Under federal and state tax law, the term "overpayment" has a specific meaning that results in it being impossible for an overpayment to occur any earlier than the original due date of the return. Therefore, even though payments are made during the tax year through wage withholding or estimated tax payments, interest does not begin to accrue as of those payment dates.

Under federal and state tax law, when filing a tax return, taxpayers can request that their tax overpayments be applied as an estimated tax payment for the following tax year or any balance be refunded. However, if the taxpayer owes an amount on a prior tax year, child support delinquencies, or other governmental debts, before a refund can be made to the taxpayer, the tax overpayment must first be credited against that other amount owed.

Interest on Overpayments

Tax overpayments typically result from excess wage withholding or estimated tax payments. However, an overpayment can also result from the refundable dependent care credit, which is an amount subject to refund that is over and above the amount of tax actually paid. California generally uses the interest rate allowed under federal law for an individual's tax underpayments to determine the amount of interest allowed and paid on tax overpayments. Interest is compounded daily, and the interest rate is adjusted semi-annually. For calendar year 2000, the interest rate was 8%. From January 1, 2001, through June 30, 2001, the interest rate is 9%.

Interest on an overpayment is generally allowed:

from the later of	to the date
<ul style="list-style-type: none">the original due date of the tax return, or	<ul style="list-style-type: none">preceding the date of the refund warrant by not more than 30 days, or
<ul style="list-style-type: none">the date the tax return is filed	<ul style="list-style-type: none">credited to the taxpayer's account

However, both FTB and the Internal Revenue Service are generally provided 45 days to process the tax return and the resulting overpayment before interest will be allowed and paid to the taxpayer. In addition, under federal and state law, interest may not be allowed when the taxpayer requests that a tax overpayment be applied as an estimated tax payment for the following tax year.

THIS BILL

This bill would require FTB to allow and pay interest on all tax overpayments from the date of the tax overpayment to the date the amount is paid. The interest that would be paid would not be compounded on a daily basis, but instead would be simple interest.

IMPLEMENTATION CONSIDERATIONS

Given the Legislature's findings and declaration and the author's intent that interest be allowed and paid from the actual date the wage withholding or an estimated tax payment was made, this bill cannot be implemented as of its operative date, January 1, 2002. As discussed below, FTB would not have the additional information that would be needed to implement and administer this bill by that date. This bill would have a significant impact on the way FTB processes tax returns and claims for returns. The full impact is not readily known. Staff is available to work with the author to resolve the following considerations and any other considerations that may later be identified:

1. As discussed with EDD staff, employers do not itemize and report to any governmental agency each date and each amount of withheld wages for each individual taxpayer. Employers only report wage and withholding information for each individual on each calendar quarter. Therefore, to implement this bill, employers would have to increase their reporting requirements to provide each date and each amount of withheld wages for each individual taxpayer within the calendar quarter. Given that this would be a new employer reporting requirement and EDD does not have a computer system that could accommodate this new requirement, it is unclear whether FTB or EDD would be responsible for administering this reporting requirement and developing any needed computer systems. The bill should be amended to specifically state which agency the Legislature would want as the agency responsible for administering this reporting requirement and developing the needed computer system and related processes.
2. The computer system, and related processes, for these additional employer wage withholding requirements, at a minimum, would need to accommodate 800,000 employers. These employers would be reporting this additional wage withholding data on 12 million individual taxpayers for at least two pay periods per month. In addition, a large number of individuals have multiple employers. To implement this bill, the bill should be amended to require employers to report the additional wage withholding information beginning January 1, 2002. The bill should further be amended so that in the following year, for tax year 2003 and years thereafter, FTB would use this additional reporting information to determine, allow, and pay interest from the date of the actual tax overpayment.
3. Employers remit wage withholding payments to EDD at various times depending upon the size of the payroll that is processed by the employer or any private sector payroll service providers that may be under contract with the employer. The remittance due dates range from the next banking day following the withholding to each calendar quarterly. These remittance due dates could result in a lag of several months between the date the payment is withheld from the taxpayer's wages and the date the payment is remitted to EDD. This bill does not indicate what date the department would use for determining receipt of the wage withholding payments: the date the employer withholds the payment from the taxpayer's wages, or the date EDD receives the payment of the withheld tax.
4. This bill requires interest to be allowed until the overpayment is paid to the taxpayer. Once FTB staff determines the allowed interest, the amount of the refund, including interest, is submitted to the Controller's office for issuance of the refund warrant. However, current law takes into consideration that the Controller's processing is outside FTB's responsibilities. Current law expressly disallows the payment of interest amounts for up to 30 days preceding the anticipated date of the Controller's issuance of the refund warrant.

This bill removes this period for disallowing interest. Under this bill, as under current practices, staff would be unable to determine the date the overpayment will actually be paid by the Controller. Therefore, staff suggests that the "30-day disallowance provision" be reinstated in this bill.

5. As discussed with the author's office, FTB may process up to 14 million tax returns during the first quarter of each calendar year. The tax returns may reflect full payment, overpayment, or taxes owed. FTB's first priority is to deposit all money received with the tax returns. FTB then processes the overpayment tax returns within 45 days of receipt to avoid the payment of interest, followed by the tax returns reflecting taxes owed the state. If FTB were to continue this tax return processing priority and yet attempt to determine the interest as required under this bill within this process, conceivably the processing of all 14 million returns would be delayed. Considering this significant impact on FTB's current tax return processing operation, as the bill moves through the legislative process, staff will need to conduct a study and develop an implementation plan for this bill.
6. This bill would also affect interest that is allowed and paid when FTB's processes claims for refunds or overpayments resulting from amended returns or state or federal audits. The above study would also need to address the changes to these processes as a result of this bill.
7. According to the legislative findings and the author's office, the intent of this bill is to allow and pay interest from the date the taxpayer actually makes the payment that resulted in a tax overpayment. However, under the bill, by reference to the date of "overpayment," interest would not be allowed for any period earlier than the original due date of the return. The author's office indicated the bill would be amended to achieve the author's intent.
8. Under this bill and current law, taxpayers who are entitled to receive a refundable dependent care credit may be allowed interest if the credit results in a tax overpayment. According to the author's office, this is not the intent of this bill, and the bill will be amended to specifically preclude the allowance and payment of interest for other than actual payments of tax made by the taxpayer.

OTHER STATES' INFORMATION

The laws of five of the larger states with tax laws similar to California's personal income tax laws were reviewed: *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states generally have laws similar to California's in the allowance and payment of interest on tax overpayments. However, the laws in *Massachusetts*, *Michigan*, and *New York*, like California, allow 45 days to process overpayments without paying interest to the taxpayer, whereas, the laws in *Illinois* and *Minnesota* generally permit 90 days.

FISCAL IMPACT

Departmental Costs

Until the implementation considerations are resolved, costs cannot be determined. However, staff anticipates that to create a new process to determine the interest as required under this bill would significantly increase the department's costs.

In addition, to develop and administer a new computer system, and related processes, to capture the additional employer reporting requirements would significantly increase the cost to state government (either FTB or EDD) as discussed under "Implementation Considerations."

ECONOMIC IMPACT

Revenue Estimate

Due to the nature and complexity of this bill, only an order of magnitude impact can be provided at this time.

Order of Magnitude			
Refunds or Credit Transfers After December 31, 2001			
Fiscal Years			
(In Millions)			
	2001-02	2002-03	2003-04*
Interest on Overpayments	-\$5	-\$445	-\$245

* Ongoing impact as well.

This estimate is based on the author's intent to allow and pay interest from the date the taxpayer actually makes the payment that resulted in a tax overpayment. It is also based on the intent to only pay interest on refunds or credits of actual tax payments that are made by the taxpayer. This estimate was computed based on the assumption that the 30-day interest-free time period for the State Controller to process refund checks will be reinstated. If this reinstatement does not occur, the processing time associated with the refund check would create additional interest payments and processing difficulties.

Revenue Discussion

The impact of this bill would depend upon the amount of overpayment for both personal income and corporate taxpayers, the length of time that interest would accrue on these overpayments, the applicable interest rate paid on the overpayments, processing time for the refunds of tax and applicable interest, and any incentive effect for delayed filing of returns this bill may generate.

The total projected interest payable under this bill for calendar year 2002 is approximately \$240 million. This includes interest payments of approximately \$50 million to corporate taxpayers and approximately \$190 million to personal income taxpayers. The current interest rate of 9% was used in the computation of these estimates.

It is projected that the current average refund processing time of 22 days will double to approximately 45 days under this bill. The projected increase in processing time is due to the complexity of the review that will have to be done on taxpayer accounts in order to fulfill the requirements of this bill.

Additionally, three more months of processing time has been added to the interest impact for refunds and credits in the first six months of 2002 because of the expected delay in processing due to the initiation of new procedures and programs to calculate the proposed interest payments. This results in the inclusion of the majority of the 2002 impact in the 2002-03 fiscal year.

Factors included in this estimate include the number of taxpayers filing under extensions, the complexity and tax amounts associated with returns filed that generate refunds or credits, and a projected incentive effect of taxpayers filing returns later due to the interest payment under this bill.

Projected refunds generated by the refundable dependent care credit were excluded from the computation of interest expense associated with this bill per the author's intent as stated above.

An offset of approximately \$12 million a year has been made to account for the inclusion of the interest payments received by taxpayers in gross income in the year received.

Taxpayers who would receive interest payments under this bill and subsequently receive additional tax assessments for the same tax year would receive the benefit of receiving interest from the date of overpayment but could only be charged interest from the due date of the return.

ARGUMENTS/POLICY CONCERNS

- Simple interest at the rate allowed under tax law is generally greater than most private short-term investments or bank accounts. Therefore, this bill could result in taxpayers purposely overpaying their tax to reap the higher return of interest paid by the state.
- The amount of an overpayment can only be determined once the tax return is filed and the tax liability identified. As previously stated, because the interest rate is greater than most private short-term investments or bank accounts, taxpayers with overpayments may begin to routinely delay the filing of their tax return to take advantage of interest that would be allowed under this bill.
- In determining what date the taxes became overpaid and interest would be allowed, a ordering rule must be established for applying the withholding or estimated tax payments against the tax. The ordering rule would establish whether the payment is to be applied against the tax beginning with the earliest payment or beginning with the last payment of the calendar year. However, if the ordering rule begins with the earliest payment, the state would have benefit of the taxpayer's money for a longer period of time, interest free, which appears contrary to the purpose of the bill. On the other hand, if the ordering rule begins with the last payment, taxpayers may encouraged to increase their withholding or estimated tax payments during the earlier part of the calendar year to guarantee themselves a tax overpayment and take advantage of the higher return of interest paid by the state.

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